

From: George, Gregory L
Sent: Wednesday, March 30, 2005 9:24 PM
To: Weaver, Brett A
Cc: Corwin, Manal S; Boykin, Richard A; Burt, Brian; Bates, Stephen R. A
Subject: RE: MS Prep Materials
Attachments: Early Adoption and Continued 936 final.PPT

It appears I sent to wrong version earlier. Attached is the version we presented at MS. Includes 936 discussion.

> -----Original Message-----

>From: Weaver, Brett A
>Sent: Wednesday, March 30, 2005 11:32 AM
>To: George, Gregory L
>Subject: RE: MS Prep Materials
>
>Greg,
>
>You have the final version of the slide deck (which is draft) that I've
>attached. This includes our discussion of using 936. Can you pls send
>that to me asap? Thanks
>

> << File: Early Adoptoin & Continued 936.PPT >>
>

>Brett A. Weaver
>KPMG
>International Corporate Services
>Seattle, Washington
>206 913 6697 (office)
>206 913 4444 (fax)
>

> -----Original Message-----

> From: George, Gregory L
> Sent: Tuesday, March 29, 2005 3:14 PM
> To: Corwin, Manal S; Boykin, Richard A; Burt, Brian; Bates,
>Stephen R. A
> Cc: Weaver, Brett A; Welsh, Anne A
> Subject:MS Prep Materials
> Importance: High
>

> Attached are some materials for your review prior to our meeting with
>MS on Friday.
>

> << File: PR Cost Sharing 122104 draft.ppt >> << File:
>Feasibility-Structural Requirements.PPT >> << File: MS Americas
>Costshare early adoption.ppt >> << File: MSPR CS Functions Shift
>12.2.04.xls >> << File: PR Modified Retail MBS flat royalty.xls >>
>

**Government
Exhibit**

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> Gregory L. George
> International Corporate Services
> Seattle, WA
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>
> Our advice in this communication is limited to the conclusions
>specifically set forth herein and is based on the completeness and
>accuracy of the above-stated facts, assumptions and representations.
>In rendering our advice, we are relying upon relevant authorities that
>are subject to change, sometimes retroactively. We will not update our
>advice for subsequent changes to authorities or interpretations
>thereof.

>
>
>



MS Puerto Rico Restructuring-- “Early Adoption” & Continued Sec. 936 Credit

KPMG Seattle/Washington National Tax
March 10, 2005

TAX

AUDIT • TAX • ADVISORY

Early Adoption Constraints

- ❖ **MSPR does not have capacity to manufacture all CDs/DVDs from day one**
- ❖ **Third party vendors continue to manufacture related CDs/DVDs during transition phase**
 - ... Vendors located in the US
 - ... MS is the principal in current vendor contracts
 - ... One contract covers both CD/DVD manufacture and FPP packaging
- ❖ **Implementation issues**
 - ... Internal Accounting/SAP
 - ... Assignment of contracts
 - ... Other

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Early Adoption Strategies

- ❖ **Phase-in** - MSPR buys into existing tech intangibles for America's Retail but chooses only to exploit rights for what they currently manufacture
- ❖ **Contract Manufacturing** - MSPR buys into existing tech intangibles for America's Retail and will exploit all rights through manufacturing and contract manufacturing with third party vendors
- ❖ **Multiple CSA's** – MSPR buys into tech intangibles only related to the products they manufacture today

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Early Adoption Tax Issues

- **The following tax issues need to be considered to determine the optimal adoption strategy**
 - Subpart F – Manufacturing Exception
 - ECI
 - Transfer Pricing
 - US Withholding Tax

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Phase-In Approach

- **Subpart F – Manufacturing Exception**
 - ... MSPR only takes benefit on product it manufactures
- **ECI**
 - ... MSPR has no trade or business in the US
- **Transfer Pricing**
- **Withholding Tax**

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Contract Manufacturing Approach

- ◆ **Subpart F – Manufacturing Exception**

- ... MSPR only takes benefit on product it manufactures

- ◆ **ECI**

- ... MSPR most likely has a trade or business in the US

- ◆ **Transfer Pricing**

- ... No additional Transfer Pricing Issues

- ◆ **Withholding Tax**

- ... Cannot license back to the US without WHT Issues

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Multiple CSA's

- ◆ **Subpart F – Manufacturing Exception**
 - ... MSPR only takes benefit on product it manufactures
- ◆ **ECI**
 - ... No USTOB Issues
- ◆ **Transfer Pricing**
 - ... How do you carve up intangibles for what MSPR currently manufactures?
- ◆ **Withholding Tax**
 - ... No WHT Issues

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Sec 936 Overview

- ✦ **Exploring the possibility continuing to take Sec. 936 credit benefit throughout FY2006 while implementing a Puerto Rican-based cost-sharing arrangement in FY2005**
- ✦ **Two possible alternatives:**
 - ... MSPR continues as the manufacturer of CD/DVDs
 - ✦ Take advantage of the Profit-Split Method in computing the credit (subject to the Sec. 936(j) cap)
 - ✦ CTI would be reduced by COGS paid to MSPR Newco
 - ... MSPR acts as a contract manufacturer for MSPR Newco
 - ✦ Use of Sec. 482 method (likely a “cost-plus” approach)

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Review of Sec. 936 Operating Rules

A corporation qualifying for the Sec. 936 credit

- ✦ Incorporated in the United States
- ✦ 75% of gross income from active PR trade or business
- ✦ 80% of gross income from PR sources
- ✦ Be an Existing Credit Claimant (“ECC”)

Determining the income of the corporation

- ✦ General rule—Sec. 482 method
- ✦ Cost-sharing method
- ✦ Profit-split method

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75% Active Business Requirement

- ❖ **75% or more of gross income from an active trade or business in PR**
 - ... Satisfied for the three-year period preceding the current year
 - ... Factual determination
 - ❖ TAM 9633003—Failed test due to limited presence in the possession and extensive use of outsourcing PR activities
 - ❖ Medchem v. Commr.; 16 TC 25 (2001)
- ❖ **Expectation that requirement would be satisfied whether or not MSPR structured as a contract manufacturer**

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80% Gross Income Requirement

- ❖ **80% or more of gross income from PR sources**
 - ... Satisfied for the three-year period preceding the current year
 - ... MSPR as a full manufacturer
 - ❖ Gross receipts less COGS
 - ❖ Other income
 - ... MSPR as a contract manufacturer
 - ❖ Gross service revenue without reduction for production expenses
- ❖ **Expectation that requirement would be satisfied whether or not MSPR structured as a contract manufacturer**

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Existing Credit Claimant

- ❖ A domestic corporation
- ❖ Engaged in an active TorB within a possession on October 13, 1995
- ❖ Made a Sec. 936 election
- ❖ Has not added a “substantial new line of business” after October 13, 1995
 - ... Consider safe harbors
- ❖ “ECC” status is expected whether or not MSPR is structured as a contract manufacturer

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Transfer Pricing—Sec. 482 Method

- ❖ **MSPR is not allowed a return on intangible property**
- ❖ **Presumably a “cost-plus” return would be appropriate**
- ❖ **The impact of structuring MSPR as a contract manufacturer is expected to be minimal**

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Transfer Pricing—Profit Split Method

- ❖ Assume continued use of “component product” definition
- ❖ Must satisfy both the Significant Business Presence Test and Manufacturing Test
- ❖ Significant Business Presence Test (assuming “65% direct labor test”)
 - ... At least 65% of direct labor costs of the product incurred in Puerto Rico
 - ... Look to affiliated group’s costs for similar “types of services” as provided by MSPR (if acting as a contract manufacturer)
 - ... It is expected that this test would be satisfied whether or not MSPR structured as a contract manufacturer

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Transfer Pricing—Profit Split Method (Cont.)

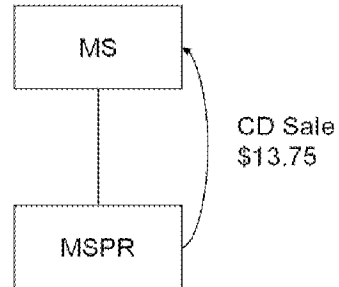
- ❖ **Manufacturing Test—MSPR must “manufacture” the product within Puerto Rico within the meaning of Reg. 1.954-3(a)(4)**
 - ... Substantial transformation
 - ... Substantial operations generally considered to be “manufacturing”
 - ... 20% direct conversion costs
- ❖ **“Covered Sales” should include sales to PRNewCo and sales of product purchased from PRNewCo**
- ❖ **Query whether MSPR may satisfy this test if structured as a contract manufacturer**

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Status Quo

Computation of MSPR TI

Receipts	100.00
COGS	<u>(85.00)</u>
Gross Margin	15.00
ROD (Net of royalties)	-
100% of Gross	<u>40.00</u>
CD	<u>55.00</u>
MSPR TI	<u>13.75</u>

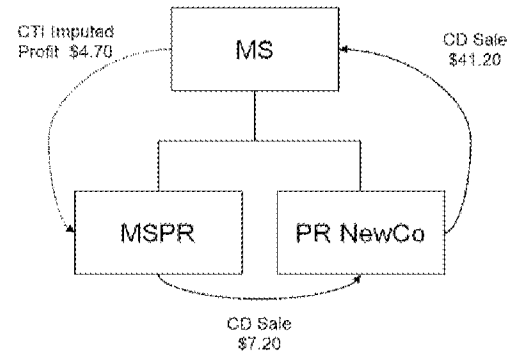


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MSPR Full Manufacturer

Computation of MSPR TI

Receipts	100.00
COGS	(41.20)
Gross Margin	58.80
R&D (part of royalties)	-
Litho & Costs	(40.00)
CTI	18.80
MSPR TI	4.70

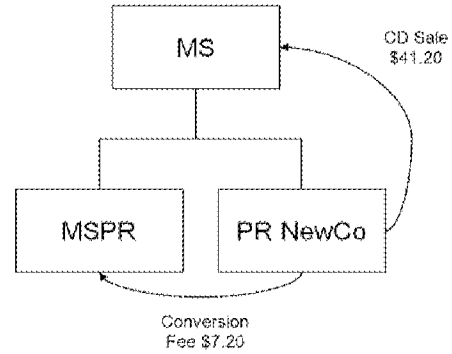


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MSPR Contract Manufacturer/Sec. 482 Pricing

Computation of MSPR TI

CCGS	5.00
Overhead	1.00
Cost Base	6.00
Mark Up %	20%
MSPR TI	7.20



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